Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of

A La Carte and Themed Tier Programming and Pricing Options for Programming Distribution on Cable Television and Direct Broadcast Satellite Systems	)	MB Docket No. 04-207

COMMENTS OF
THE PROGRESS AND FREEDOM FOUNDATION

I. INTRODUCTION

The Progress & Freedom Foundation ("PFF" or "Foundation"), a private, non-profit, non-partisan research institution established in 1993 to study the digital revolution and its implications for public policy, hereby submits these comments in response to the Public Notice issued on May 25, 2004 in this proceeding.[1] The Commission is soliciting comment on questions relating to the provision of a la carte and "themed tier" services on cable television and direct broadcast satellite systems. According to the public notice, the information gathered will be used to prepare a report to Congress addressing questions regarding "the ability of multichannel video programming distributors ("MVPDs") to provide such services to customers on a voluntary basis."[2]

[1] Public Notice DA 04-1454, May 25, 2004. The views expressed in these comments are the views of the comments' authors and do not necessarily reflect the views of the directors, officers, or staff of the Foundation.

[2] Id.

In our view, the MVPD market is sufficiently competitive that the operators will offer consumers the video services they demand on the basis (ie., bundled or not) that consumers wish to receive them at the prices consumers are willing to pay. In other words, to answer the Commission's question, reframed only slightly, in today's competitive environment, cable and satellite operators have sufficient incentives, on a voluntary basis, to offer customers the services they want in the form they want them at prices that customers are willing to pay for such services. The fact that the cable and satellite industries, like other network industries with very large up-front costs and low marginal costs, employ tiering (or bundling) in offering services does not mean that the marketplace is not competitive and that consumers are not being well served. It simply means that such tiered pricing is the most economically efficient way to offer service to the benefit of all consumers. It leads to a greater diversity of programming at lower prices.

In the comments below, we will first very briefly discuss the nature of the multichannel video marketplace, including its competitive status. Then, having that perspective in mind, we will explain why tiered pricing such as that employed by cable and satellite operators promotes economic efficiency and consumer welfare. It will be evident that it would not represent sound policy for Congress or the FCC to mandate that channels be offered on an a la carte basis, or otherwise dictate the content of program packages.

II. THE MULTICHANNEL VIDEO MARKETPLACE IS COMPETITIVE AND OFFERS CONSUMERS AN ABUNDANCE OF CHOICES

Each year the FCC conducts a study on the status of competition in the marketplace for the delivery of video programming and reports to Congress. In

considering the issue of whether there is any justification for imposing any mandates relating to program offerings, it is well to have in mind these annual reports, which indisputably show that over the past decade the video marketplace has become progressively more competitive.

A review of the conclusions of the most recent report demonstrates the extent to which consumers now have choices among suppliers of video programming as a result of marketplace competition. In the *Tenth Annual Report*, released in January 2004, the Commission concluded:

> Overall, due, in part, to Congressional efforts made over the past decade, technological advances and investment in new platforms for delivering video programming, the vast majority of Americans enjoy more choice, more programming and more services than any time in history. In addition to an increase in the number of video channels, cable operators and other MVPDs also now offer advanced video services and many non-video advanced services.[3]

The report points out while approximately 75 percent of MVPD subscribers received their video programming from a cable operator in June 2003, when the most recent data was collected, "most consumers have the additional choice of at least two national DBS providers."[4] DBS currently has over 20 million subscribers, an increase of over 11 percent since the previous annual report.[5]

In addition to observing DBS's continued rapid growth, the report surveyed other existing video distribution vehicles and technologies, including broadband service providers; wireless cable systems; SMATV operators; broadcast television stations,

[3] Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, MB Docket No. 03-172, FCC 04-5, January 28, 2004, at para. 4.
[4] Id., at paras. 5 and 6.
[5] Id., at 16.

including ones offering DTV service; home video sales and rentals; and the Internet.[6] The point is not that all of these distribution vehicles are presently comparable to cable and satellite providers; they are not. But they do offer consumers additional video programming choices and, to a greater or lesser degree, are competitive factors.

The Internet is a good example, of course. As the Commission notes, when it began issuing its annual reports, the Internet was not even in use. Now, although it still may not be "a direct competitor" to traditional video services in the Commission's view, "real-time and downloadable video accessible over the Internet continues to become more widely available and the amount of content is increasing."[7] And the agency recognizes that the local telephone companies and electric and gas utilities, while presently not serious competitors, do offer service in scattered locations and, at least with respect to the utilities, are potentially "competitively significant".[8]

The development of a competitive MVPD marketplace has spurred operators to provide consumers with a dazzling array of programming choices and new services. According to the *Tenth Annual Report*, there are now over 330 national cable networks, plus over 80 regional sports and news networks.[9] Significantly, the Commission reports

[6] Id., at para. 16.
[7] Id. Just this week, the Wall Street Journal reports on new partnerships formed between companies with content and hardware and software companies to facilitate the delivery of video programming over personal computers. According to the report, "the move advances a big goal for hardware and software companies: turning the personal computer into an entertainment hub that zaps movies, music, photographs and other diversions to televisions and players around the home." Sarah McBride, "Studios to Set Deals in Bid to Get PCs to Show Movies," The Wall Street Journal, July 14, 2004, at D4. This will just be another way in which consumers will be able to choose to receive programming, no doubt under a variety of pricing plans.
[8] Id.
[9] Id., at paras. 142 and 158.

there are 61 new networks that are planned in various stages of development, but not yet operational.[10]

After investing over $75 billion to rebuild and upgrade their facilities since passage of the Telecommunication Act of 1996, the Commission points out that "cable operators offer, on average, 70 analog video channels, 120 digital video channels, high-definition television programming, video-on-demand, and non-video services, such as high-speed Internet access service, and telephone service."[11]

III. TIERED PRICING PROMOTES LOWER PRICES AND GREATER PROGRAM AVAILABILITY

Tiering has played an important role in encouraging the investment and expenditures of funds that has made possible the vast array of choices that consumers have available in today's video marketplace That choice would be seriously threatened by an a la carte requirement that would interfere with the ability of MVPDs to offer programming in bundles or "tiers" as they currently do. Indeed, the practice of offering programming in bundles is what we would expect in industries with the characteristics of cable and DBS and is consistent with economic efficiency considerations. An a la carte requirement would interfere with the ability of MVPDs to set prices efficiently, resulting in higher prices, lower viewership and less program availability for consumers.

A. MVPDs are High-Fixed-Cost, Low- Marginal-Cost Industries

As is typical in the telecommunications and information technology sectors, the production and distribution of cable and DBS programming to consumers is characterized by large up-front fixed (and sunk) costs and significant economies of scale—i.e., declining costs of serving additional consumers. Independent networks face start-up

[10] Id., at para. 146.
[11] Id., at 18.

costs of $10-30 million annually.[12] And, the average yearly operating expense for a cable network is over $125 million.[13] Most of this—about 65 percent—consists of programming costs.[14] Programming is subject to large "first-copy" costs and low costs of replication and distribution. Once an episode of the Sopranos is produced, for example, the cost of letting additional viewers see it is very low

B. Differential Pricing is Necessary for Efficiency in These Industries

In industries such as these, with large up-front costs and low (or even zero) marginal costs, the economist's traditional prescription to price at marginal cost is not a viable way to cover the costs of production. In these industries, efficiency typically requires some form of "differential pricing" in which prices differ across consumers based on demand considerations.[15] The tiered pricing model that MVPDs have developed facilitates such differential pricing.

A simple example illustrates why differential pricing is required in these circumstances and promotes efficiency. Suppose it costs $12 to produce an episode of the Sopranos. Viewer A is willing to pay $10 to watch the episode and Viewer B is willing to pay $5. Since the total benefit of the program —$15— is greater than the cost —$12— viewers will benefit by having the program produced. But it will only be produced if some sort of differential pricing plan is adopted. To see this, consider the following pricing alternatives:

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[12] Kagan World Media, Economics of Basic Cable Networks 2003. at 77.
[13] Kagan World Media, Economics of Basic Cable Networks 2004, at 25 (derived from data showing total expenses for the 108 networks of over $13.6 billion.)
[14] Id, at 25.
[15] See, for example, Hal R. Varian, "Differential Pricing and Efficiency," *First Monday*, at http://www.firstmonday.dk/issues/issue2/different/

1. The price is set at $10. In this case, Viewer A would subscribe and pay $10, but the total revenue ($10) would not be sufficient to cover production costs and the program would not be produced.
2. The price is set at $5. In this case, both viewers would subscribe, paying $5 each for a total of $10—again not enough to cover production costs.
3. The price is set at $9 for Viewer A and $4 for Viewer B. In this case, both viewers would subscribe, yielding total revenue of $13, which is sufficient to cover production costs.

In this example, there is no single price that yields enough revenue to cover the costs and get the program produced. What is required is a price structure that charges different prices to Viewers A and B according to the intensity of their demand—their willingness to pay. Any differential-pricing plan (and obviously there is more than one) that charges Viewer A $10 or less and Viewer B $5 or less and also yields revenues of at least $12 will yield sufficient revenue to get the program produced and make consumers better off.

A slight variation of this example illustrates how differential pricing can lower prices by spreading the costs among more viewers. If Viewer A's willingness to pay were $12 (rather than $10), then he could support the Sopranos all by himself at a flat price of $12. But differential pricing—offering the program to Viewer B at a price of $5 or less—would induce Viewer B to subscribe and defray some of the cost. The price to Viewer A could then be reduced.

C. Tiering Facilitates Differential Pricing by Segmenting Viewers

In order for the MVPD to implement a price differentiation plan it needs to be able to differentiate consumers according to their willingness to pay (in the example above, identify which viewer is willing to pay $10 and which is willing to pay $5). This, of course, is typically difficult to do because viewers will not readily reveal that information. To overcome this problem, different industries have developed industry-

specific ways to induce consumers to self-select into different groups according to the intensity of their demand. Airlines, for example, use techniques such as advance-purchase or Saturday-night stay-over requirements that have the effect of separating business travelers with a high willingness to pay from other travelers with a lower willingness to pay.

In the MVPD market, tiering—the offering of different bundles of programming—has developed as a way to induce viewers to separate themselves into groups according to the intensity of their demand for TV viewing. For example, individuals who purchase the basic tier presumably have a relatively low viewing demand. Individuals who purchase the premium networks or the sports packages have a much higher demand for TV viewing and can be charged correspondingly higher prices. The MVPDs as well as their viewers have an interest in the various tiers being designed in a way that separates viewers according to the intensity of their demands.

D. Tiering Facilitates Differential Pricing by Reducing Dispersion in Willingness-to-Pay

In addition to segmenting viewers according to their demand characteristics, there is another way in which bundling enables the MVPDs to increase their revenues and produce programming that otherwise might not be produced. A simple example illustrates the point. Assume that both HBO and Showtime cost $75 to produce. Viewer A is willing to pay $50 for HBO and $25 for Showtime; Viewer B's preferences are the reverse—he is willing to pay $25 for HBO and $50 for Showtime. As the following example shows, if HBO and Showtime are offered separately, on an a la carte basis, neither will be able to cover its costs. If offered together as a tier, however, both will be produced. To see this, consider the following pricing alternatives:

1. HBO and Showtime are offered on an a la carte basis for $50 each. In this case, Viewer A would want to subscribe to HBO, but not Showtime, and Viewer B would want to do the reverse. Both HBO and Showtime would earn $50—not sufficient for either one to cover costs. So, neither would be offered.
2. HBO and Showtime are offered on an a la carte basis for $25 each. In this case, both viewers would want both networks. But the networks would only be able to earn $50 each—not enough for either of them to stay in business.
3. HBO and Showtime are offered as a tier for $75. In this case, both viewers would subscribe to the tier. Total revenues are $150—enough to cover the costs of both networks.

In this example, tiering enables the producers to increase their revenues and better satisfy their viewers' demands, because it reduces the dispersion of the willingness to pay for the bundle relative to the individual components.[16] Importantly, tiering in this example accomplishes exactly what perfect differentiated pricing would if the MVPD knew the individuals' willingness to pay for the various programming. With perfect differentiated pricing, Viewer A would face prices of $50 for HBO and $25 for Showtime and would subscribe to both networks. Similarly, Viewer B would face prices of $50 for Showtime and $25 for HBO and would purchase both. Tiering accomplishes the same thing without requiring the same (unknowable-in-advance) level of information about specific individuals' preferences.

E. Other Reasons for Tiering

Tiering also accomplishes other purposes, one of which is to provide viewers with "option value". When viewers purchase a bundle of programs, they have the option of watching programming that they might not have purchased separately. It is difficult to see how option value could be offered on an a la carte basis.

Tiering can also be a way for new networks to get started and introduce themselves to viewers. Starting a new network is both expensive and risky. As discussed

[16] This is discussed in Carl Shapiro and Hal R. Varian, *Information Rules – A Strategic Guide to the Network Economy*, Harvard Business School Press (1999).

above, start-up costs are on the order of $10-30 million a year. A startup cable network needs to reach 30-40 million subscribers before national advertisers take notice, which can be expected to take many years.[17] Viewers can get acquainted with the offerings of a new network that is included in a tier they are already receiving without having to make the decision to subscribe to the network on an a la carte basis. This can make it substantially easier for new networks to establish themselves, especially independent ones not affiliated with major media companies. This, in turn, increases the diversity of programming available to consumers, a result policymakers supposedly would want to encourage.

IV. CONCLUSION

For the reasons explained above, any move to impose a mandatory a la carte or themed-tier regimen on cable, satellite, or other multichannel video operators would be unwise and represent unsound policy. We are fortunate to live in an environment in which there is competition among video programming distributors and in which consumer choice abounds. Surely, as broadband at higher bandwidths becomes even more ubiquitous, video streaming over the Internet likely will provide consumers with even more choice of programming under different models. In any event, and most importantly, policymakers must understand, as explained in these comments, why tiering, or bundling, of programming promotes economic efficiency, thereby lowering prices for consumers and increasing the diversity of programming available to them. Interfering

[17] According to Kagan, the average basic cable startup takes six years to attract 38 million subscribers. Of the 43 start-ups for which Kagan had complete data, only 21 attained over 30 million subscribers in their first six years of operation. See Kagan World Media, Economics of Basic Cable Networks 2004, at 25.

with the ability of MVPDs to engage in these practices would have serious adverse effects for consumers.

Respectfully submitted,

Thomas M. Lenard, PhD
Senior Fellow and Vice President
for Research

Randolph J. May
Senior Fellow and Director of Communications
Policy Studies[18]

THE PROGRESS & FREEDOM FOUNDATION
1301 K Street, N.W.
Suite 550 East
Washington, D.C. 20005
(202) 289-8928
(202) 289-6079 (facsimile)

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